# N. A. C. A. BULLETIN

Vol. XXI, No. 15 April 1, 1940

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This Bulletin is published semi-monthly by the National Association of Cost Accountants, 385 Madison Avenue, New York. Subscription price, $10.00 per year. Entered at the Post Office, New York, N. Y., as second-class matter August 28, 1925, under the Act of March 3, 1879.

## EDITORIAL DEPARTMENT NOTE

Progress is being made gradually in the development of methods for applying the costs of distribution to territories, classes of customers and products. Because of the greater proportion of indirect expenses involved and less definite relation between cause and effect in the case of distribution costs as compared with production costs, the results to be obtained in the application of the costs of selling products will never be as definite and provable as in the case of manufacturing cost accounting. At present cost accountants are going through the process of trying various methods and principles, exchanging views and attempting to arrive at a general agreement on some of the less controversial points involved. The two articles in this issue of the *Bulletin* should contribute to a better understanding of some of these points.

The author of our first article, Alden C. Brett, is a graduate of Massachusetts State College and the Bentley School of Accounting and Finance. For the past nineteen years he has been associated with the Hood Rubber Co. of Watertown, Mass., and has worked successively in the positions of Internal Auditor, Manager of Accounting, Manager of Branches, Controller and now holds the position of Secretary-Treasurer. He is also President of the Arrow Mutual Liability Co. Mr. Brett is a Past President of our Boston Chapter, and last year took the part of President in the panel discussion of internal auditing at the Atlantic City convention.

Norman B. Clark, author of our second article, received his undergraduate training at Harvard and subsequently received the M.B.A. degree from the Harvard Graduate School of Business Administration. He is a California C.P.A. and a member of the California Society of C.P.A.'s. Since 1926 Mr. Clark has been connected with Woodbury College in Los Angeles, where he is Head of the Accounting Department. During the period from his graduation from Harvard in 1917 until 1926, Mr. Clark served as Auditor with Ernst & Ernst, as Manager for the Meissner Leather Co., and as a Partner of Clark & Demerritt of Boston. He is a Past President of our Los Angeles Chapter.

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APRIL 1, 1940

# THE ROLE OF THE ACCOUNTANT IN THE CONTROL OF DISTRIBUTION COSTS

By Alden C. Brett, Secretary-Treasurer,
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THE function of control in the distribution field or any other field is not exercised by the accountant. Control is a function of management, of the men who have the authority to say yes or no. The accountant, however, has an important place in this process. The first essential to control is a knowledge of the facts. It has been wisely said, "Given a full knowledge of the facts, decisions make themselves." It is the accountant's job to furnish management with all the facts presented in such a way that their meaning will be clear.

A second essential to control is a well thought out plan. This ordinarily means a budget with underlying standards, and it is needless to explain to you the accountant's place in this process.

This means, therefore, that the accountant will make himself of most value in the process of control if he compiles complete and accurate distribution costs and presents them in an understandable way. We can, therefore, well afford to spend our time in the consideration of this part of the accountant's job.

### *Work on Distribution Costing in Pioneering Stage*

This paper will be pretty much a "how-we-think-we-ought-to-do-it" or "how-we-imagine-it-might-be-done" dissertation. It will not be a "how-we-do-it" article on distribution costing, because generally speaking it isn't being done. An honest-to-goodness distribution cost setup is a rare animal.

There has been another viewpoint forced on us lately, that I might call the "how-are-we-to-do-it-for-the-Federal-Trade-Commission" viewpoint. Many of us who, in our own estimation at least, have been considered respectable and law abiding citizens, have been summoned to prove by the means of distribution cost accounting that we are not criminal malefactors. So most of us struggle along from day to day with the old-time stuff and resort to special analyses with fancy and improved distribution factors when the commission orders us to come across with the proof.

In tackling the problem of distribution costing and the use of such costs in the control of distribution functions, we are therefore entering a field in which little work has been done. Its exploration is still in the pioneering stage. This field begins at the factory door and includes all those activities undertaken to place the goods in the hands of the customer and return the proceeds of the sale. There is always a marginal territory between the factory and the marketing field in which lie such functions as warehousing, packing and shipping, but whether these are classified as one or the other is of little importance in the solution of our problems.

*Distribution Facilities and Functions*

To carry on these marketing activities, the manufacturer must provide certain facilities and perform certain functions which will vary with the product handled and the length to which the manufacturer projects his efforts into the distribution field. The extent to which all these marketing facilities and services made available by the manufacturer are utilized by particular customers or classes of customers varies considerably. Some buy only from hand to mouth from the nearest available stock, do no advertising of their own, pay their bills only when pressed to do so and require continuous attention from salesmen and service men. Others maintain central warehouses, buy in carload lots, have their own private brands, do their own advertising, require little or no solicitation, pay their bills promptly and do their own service work.

Between these two extremes there are dealers who perform these service functions in varying degrees. From the cost standpoint it is not important whether we call our dealer outlets, jobbers, chain stores, mail-order houses, department stores or ordinary small retailers, or what function they perform in the general scheme of distribution. Our problem is to determine, out of the full range of services which some one must provide to distribute the product, which of these it is necessary for the manufacturer to furnish in the case of any individual customer, and what is the manufacturer's cost of furnishing these services in each particular case.

This question of cost, as I have mentioned previously, finds practical application in the situation created by the Robinson-Patman Amendment to the Clayton Act, under which the manu-

facturer may find himself called upon to justify differentials in the prices charged to different customers by differences in the cost of serving them. When such a question of discrimination arises, we as accountants must determine by costing the service required whether or not discrimination actually exists.

*Problem Differs from Factory Cost Accounting*

As we tackle such a job we find that there are no "recognized methods" of cost finding in the distribution field similar to those in the factory; that if one would know what his selling and delivery activities are costing him per unit, he must set up his accounts as they best seem to fit his needs. There are few recognized rules.

One reason for this is that the costing of activities in the field of distribution presents a far more difficult problem from costing in the field of manufacture. The difference is akin to thinking in terms of three dimensions instead of two. In the factory we are costing various products passing through departmental processes, a two-dimensional problem. In the field of distribution we have the same products handled through various departmental channels represented by various methods of sale, but superimposed on this another step caused by the fact that our product is usually sold to various classes of customers underlying which are groups and individuals. We thus find that to figure the cost of doing business with these individual customers, we must deal with products, methods of sale, and customers—a three-dimensional problem.

A second reason for the greater difficulty in costing distribution is that the physical factors in the factory are under better control. Manufacturing is carried on at one or, at most, at a small number of locations. Within fairly narrow limits the management in the factory can determine the conditions under which the work will be done. Specifications, quantities and materials are within its control. The effect of the personal equation is limited to the individuals within the productive unit itself. In the distribution field the customer is a controlling rather than a controllable factor, and his wishes and pecularities govern the method of handling every transaction.

A third reason for the more rapid development of factory costing has been the attitude of management. Factory management has been eager to measure its accomplishments in terms of reduced cost per unit. Sales management, on the other hand, has been prone to measure its results in terms of increased sales and to look to this method to increase its profits rather than the efficiency with which its operations are conducted.

This explanation is partly an apology for cost accountants in general, and the progress they have made in the development of the art, partly a personal apology for the inclusiveness of the solutions which will be offered to some of the problems treated later, and partly also for my own temerity in entering the field at all.

As accountants, it seems to me that it is a serious indictment of own own group that only as a result of legislation conceived for an entirely different purpose have we been forced to give the subject of distribution costing the attention it deserves.

*Factory Techniques Helpful*

We can learn much of the technique of distribution costing from our knowledge of the technique used in the factory. Its essential tools are also job analysis and time study. In the field of distribution these tools have been used but little. Their application means a detailed study of such operations as salesmen's calls, salesmen's travel, picking, packing and shipping orders, order writing, billing and all the details of the commercial operation. We are not altogether on unfamiliar ground, however, because we have this knowledge of factory technique to guide us.

Suppose we have the job of setting the standard factory cost of a new product which, in general, utilizes present factory facilities, but is entirely different from anything we are now making. Our procedure for doing this is well understood. We have a cost estimating sheet on which are listed in detail all the items of material, the labor operations, and all the details of departmental overheads which are made use of in the production of any of our products. We match this up with our specifications and from this list we pick those which apply to our new product. We build up a material cost using the new materials specifications; we determine how the article is to be made, what machines or facilities

are to be used, and from this knowledge enter on our estimate sheet the cost of passing our product through these various operations, applying previously determined cost factors, including those for factory overhead, on a weight, bulk, direct labor or other basis as seems proper. In this way we eventually arrive at an estimated factory cost. Now the trouble is that most cost sheets end right at this point, and we take our answer to the management and leave them struggling with the problem of whether, with a probable selling price of $2.00 and a factory cost of $1.37, we can make any money.

Let us suppose, however, that we do not stop at this point; that we have been furnished with further specifications. Our product is to be sold on a nation-wide basis, it is proposed to make a special advertising appropriation, it will be stocked in our branches, a certain class of customers will be solicited by our branch salesmen. Isn't it perfectly simple to suppose that we should have previously developed cost factors for these commercial operations, also, just as we do in the factory, and should be able to build a complete cost, including commercial overhead, taking the product all the way to its final resting place with the customer?

It is the concept of such a complete cost which I want to explore with you by touching on the problems of costing the commercial operations. Does it take a great deal of imagination to visualize a standard cost setup in the distribution field with volume and efficiency variances applying to the functional distribution units just as we have in the factory?

*Proper System of Accounts Is First Need*

The initial step in the process of sales cost accounting is the setting up of a proper system of accounts for the recording of commercial expenses. In the commercial field, as in the factory, there are only a limited number of things for which we can spend money or incur expense. But the same object of expenditure, because of the use to which it is put, may be made to accomplish entirely different results. Thus wages paid in the accounting department and wages in the shipping department, while they are both wages, perform entirely different functions. There will be times when we we will require a record of expenditures on each of these bases. For purposes of expense control we will want to know our total

salaries, rent, depreciation, etc., but for purposes of applying costs these are of little use to us and we must have functional group totals which represent the cost of doing some definite thing.

*Primary and Functional Classification of Accounts*

At the start, therefore, we must recognize that there are two factors which must be considered in setting up our accounts. First we must set up a list of accounts which will record expenses on an object-of-expenditure basis. These may be called basic or natural accounts; for want of a better name I shall refer to them as "primary" expense accounts. The second requirement is a grouping of these primary accounts under "Functional Departments," which in turn many times are also loosely referred to as "accounts" but which really represent an assembly of the primary expenses which go to perform a specific job. This is recognized factory accounting technique.

The following is a representative list of primary expenses. You can see that they represent the broad classes of things or services for which money may be spent.

1. Salaries and wages
2. Travel
3. Rent
4. Maintenance and repairs
5. Taxes
6. Insurance
7. Heat, light, power, water
8. Materials and supplies purchased
9. Communication
10. Transportation
11. Services purchased
12. Losses

It is obvious that such expenses spread across the entire range of all business activities, both factory and commercial, and, consequently, have little value in themselves in determining the cost of carrying on the various functions of distribution or, further, in determining the cost applicable to a product or a customer.

To complete our account setup, therefore, we must group these primary expenses under functional departments which will give us totals representing the cost of doing something, of carrying on some specific commercial activity. All these primary expenses will then be applied specifically to one or more functional departments. Our setup, however, cannot be accomplished as simply as this would indicate. There are within any organization certain functional departments which do not work on the product directly but which facilitate the work of other departments. These con-

stitute part of what we call overhead. They furnish an assembly place for primary expenses which perform as a group a single function for several operating departments. Office expense is a good illustration of such a group.

For convenience in handling, the primary expenses constituting the office expense in the account setup of any department may be grouped and shown as one item under that heading. As a general principle, this method of grouping related primary expenses can be applied wherever the same basis of allocation can be properly used.

The primary expenses constituting the trucking and the maintenance charges should also be collected on a job-order basis and applied specifically to the functional departments benefited. Likewise the primary expenses making up the rental charge for floor space usage should be accumulated as rental expense and applied specifically to functional departments on the basis of the space occupied.

*Functional Account Groups*

In such cases the group name "Office Expense," "Trucking," "Maintenance and Repairs," or "Rental Expense," will appear under the Functional Department rather than the primary expense account names.

An illustrative list of functional departments for a representative business might be somewhat as follows. Each of these functional departments will have underlying a group of primary accounts.

FUNCTIONAL ACCOUNT GROUPS

1. Manager marketing
2. Manager commercial research
3. Manager merchandise
4. Manager branches
5. Manager accounting
6. Office manager
7. Manager credit and collections
8. Home office selling
9. Manager advertising and sales promotion
10. Factory warehouse
11. District warehouses
12. Branches

As the names indicate, such functional groups should represent the responsibility of some one person in the commercial organization. This setup is important because control can be exercised only through people, and our accounts enable us to control

only when they give us a clear picture of what has been accomplished within the scope of the responsibility of each person charged with operating duties. Apply this test to your account setup, and see if you have mixed accounts when viewed from the standpoint of responsibilities.

*The Problem of Allocating to Products and Customers*

In the process of recording we automatically analyze our expense totals to these functional accounts. At this point many systems of commercial accounting end. In reality this is the point of beginning. In order to meet our requirements, if we are called on to justify our price differentials under the Robinson-Patman Act, or to furnish us with a sound basis for price making, we must further allocate these functional totals: first, to lines of product and classes of customers; and then to individual products and individual customers.

The reason for the greater complexity of the problems of costing distribution activities now becomes apparent. Whereas in factory costing a division along product lines is all that is required, in the costing of commercial activities we have not only a costing by lines of product but also by customer classes, so that a breakdown of total costs may be made by lines of product, classes of customers, and lines of product under customer classes to lead ultimately to a cost for individual items to individual customers.

It might be well to mention here one cardinal principle of costing which will seem to be elementary and self-evident to most of you but which is nevertheless often carelessly neglected. When, from the nature of the physical setup, it is possible to make direct charges to a product division or to a customer class, proper sub-accounts should be set up under the functional account headings and direct charges made to these sub-accounts, thus making further analysis or allocation unnecessary. If, for instance, the company maintains a separate sales organization selling Product A only, the accounts for salaries and commissions and sales force travel, should be subdivided so as to furnish separate accounts for Product A and for other products so that direct charges of the salaries and travel of the Product A salesmen can be made. The same will apply if the company has separate sales forces selling to jobbers or to chain stores only. Separate sub-accounts for job-

bers and for chain stores will then make possible the direct charging of the salaries and expenses of these particular salesmen.

*Three Rules*

The principle, therefore, is that direct charges should be made wherever possible. Before we tackle the problem of allocation let me state three abstract rules which again are elementary but not always understood.

1. When a single product is sold through a single sales department to several classes of customers, the allocation of expense to sales departments will automatically allocate the expense to the product, and this expense can then be further allocated to customer classes and to individual customers on the proper bases.

2. When several products are sold through a single sales department to a single customer class, the allocation of expense to the sales department will automatically allocate selling expenses specifically to the customer class, and the expense can then be prorated to product classes on the proper bases.

3. When several products are sold through a single sales department to several classes of customers, the selling expense allocated to the sales department can then be allocated initially to either customer class or to product class, whichever appears most convenient.

If we presume that we now have our accounts set up and our expenses recorded under these accounts, it will next become necessary to determine the bases to be used in allocating these account totals to product and to customer. There is no mystery regarding the methods of distribution or the bases to be used. Cost accounting is primarily a problem of expense distribution, whether in the factory or the selling field, and the solution of this problem is simply a matter of applying common sense and good judgment together with a certain amount of ingenuity.

*Technique of Expense Distribution*

In the selling field we will use as the basis for departmental distribution many factors which are entirely foreign to the manufacturing field. There is a rather definite technique which will enable us to decide how to distribute the expenses of any functional

department. In the first place, we must answer what are really obvious questions.

1. What is this department set up to do?
2. What are the individual steps taken to accomplish this result?
3. Are they repetitive individually or in groups?
4. If so, can these repeated operations be segregated to products or to customers and thus constitute a proper basis for allocating expense totals?

Thus, if a salesman calls on his customer and sells him one class of merchandise, the number of calls or the time spent can be used as a basis of allocating salesmen's expense to customer groups or to individual customers and automatically to the single product, but if during these calls he sells several classes of merchandise, while the allocation of expense to the customer will be made as formerly, the allocation of expense to the product cannot be made directly through the medium of the call but some arbitrary basis, such as the number of units or the value sold, must be used. This brings up the old argument as to whether expense incurred for the benefit of two or more products should be allocated prorata or on an arbitrary basis, or should be borne on the basis of the results obtained. I have chosen this latter basis but please don't ask me to argue the point.

*Bases for Distributing Commercial Costs*

Some of the bases which will be used in the distribution of commercial accounts are as follows:

1. *Factory Cost of Sales*

   This is the basis for which you will ordinarily find the most use. In most cases it is preferable to net sales, because if we use net sales we include as a difference in our distribution factor the very differential which we are trying to measure or substantiate. Let me illustrate: Suppose we are distributing the cost of the president's department to classes of customers. If we select net sales as a basis, the allocation of this cost to the jobber group as compared with the retailer group will be smaller than if cost of sales is used because of the lower unit price basis to the jobber.

2. *Net Billed Value of Shipments*

   This will be used when the amount of the expense depends directly on the net amount billed as bad debt expense or cash discount.

3. *Number of Shipments*

   This will be used in allocating such items as shipping expense.

4. *Number of Items Billed*

   Used in allocating billing and bookkeeping expense; in cases where there is little variance in the average number of items per invoice as between product or customer class, the number of invoices, which usually is the same as the number of shipments, may be used.

5. *Number of Units Shipped*

   This will be used in preference to the number of shipments when the average number of units in a shipment varies considerably between product and customer classes.

6. *Number of Orders Taken*

   This will be used in allocating order department expenses.

7. *Number of Calls*

   As illustrated later, this is the usual basis for distributing direct selling expense.

8. *Time Spent on Calls*

   Where the time spent on different calls by one salesman varies because of inherent differences in the customer class or the product, the time spent rather than the number of calls should be used.

9. *Floor Space Used*

   For the allocation of the rent factor.

10. *Inventory Value*

    In distributing insurance, taxes on merchandise, and similar costs.

11. *Inventory Units*

May be used for distributing warehousing costs where there is little physical difference as between products.

12. *Weight*

13. *Bulk*

These factors should be used for the distribution of warehousing costs where there is considerable difference in the weight or bulk of various products.

In the process of distribution most of the functional account groups can be distributed as one total, ignoring the underlying primary expense accounts. Facilitating departments will be distributed to what I have called functional departments before the distribution to customer or product.

*Direct Selling Costs*

So far I have attempted to cover the methods of recording and building up the accounts in a very general way; to give you the overall setup and an idea of the technique which should be given general application; and have mentioned and explained the use of some of the distribution bases. We cannot attempt to go into detail in regard to the methods to be used in allocating all the functional accounts to customer and to product; that would require much more space than we have at our disposal. We can, however, consider one area of the distribution field in which we find perhaps the largest variations in practice and in which, therefore, the accountant will find his greatest difficulty. This is the field of direct selling.

This function is probably under the least control of any of the factory or commercial functions. It is performed in a great variety of ways. Generally speaking, we think of direct selling as the work carried on by a salesman who calls on his customers and sells them his merchandise. There are many other kinds of selling which are usually combined with that of direct solicitation in varying degrees. We have telephone selling, direct mail solicitation, catalogue selling, and many others. Let us consider, however, the

salesman who travels over a definite territory, driving his own or a company car, perhaps carrying samples with him, and writing orders to be delivered from a factory or branch stock.

The technique of costing this selling activity is not different in principle from that of costing a factory operation. In either case we have the problem of measuring productive effort and properly applying the cost. First, as I mentioned previously, we must make a job analysis and decide what our salesman does. We shall find that he does several things, some of which promote the company's business, some of which are better not mentioned here. He travels, he calls on his prospect, he waits to see him, and he has an interview. This process is repetitive in the main although the exact procedure varies in every case. Now what is the part of this series of things that accomplishes the thing we want done? Further, is this action of the salesman of such a repetitive nature that its costs can be figured, and if it is figured, can it be used in determining the cost of selling the product to the customer?

The travel time varies with the location of the customer. This matter of location may be significant to us under certain circumstances. If a certain class of customers or the customers who buy a certain product are located in a relatively different area, perhaps more remote or difficult to reach so that travel is more costly, we may need to segregate such travel and account for it separately. I have in mind a salesman who sells a mechanical appliance to the general run of manufacturing plants but who also sells a special piece of equipment used only by smelters which are usually located near the mines. The travel necessary to reach this latter class of customers with this special item is difficult and costly and in the interests of proper costing should be segregated.

If we have a problem as to just how much territory a salesman shall cover, whether to add to it or reduce it, we may need segregated travel records. Some of us have made attempts to route our salesmen and to schedule their time. This can accomplish much, but it has obvious limitations. If we have committed ourselves to a policy of general coverage, probably the best course is to treat all travel as unproductive time, loading it on to the productive just as we do in the factory. The difference between the salesman and the factory worker is that a much greater part of the salesman's time is unproductive and that, therefore, the loading is much

heavier. With this condition it is obviously essential to get as accurate a record of the time that can be classed as "productive" as possible, but this is never easy to do.

*Use of Productive Time in Applying Direct Selling Costs*

What, then, can be considered as productive time on the part of the salesman and can this be used as the basis for cost allocation? It is during the call that the salesman is in contact with the customer and it is during this time that the sale, if any, is made. Let us look, therefore, at the calls themselves. These vary in length; some are productive of orders and some are not.

If a worker in the factory goes through an operation which is designed to produce a certain result and his effort is unproductive for some reason or other, we have an element of waste which is usually recorded separately for purposes of control and which is eventually charged into the departmental overhead.

An academic friend of mine advocates that this method would have considerable merit if applied in the selling field, that all salesmen's calls should be costed either on a time or a unit basis, and that those productive of orders should be classified as productive selling effort whereas those which do not result in orders should be classified as unproductive and charged as selling overhead. His contention is that such a record of salesmen's unproductive effort constitutes a valuable tool for sales management in judging salesmen's relative efficiency. I am not advocating this idea, simply passing it on for what it is worth.

If there is no inherent difference between customers or products which causes one call to be longer than another, but the difference in length is due only to the idiosyncracies of the customer, the call itself can be used as a unit, the length of the call in time can be ignored, and the number of calls can be used as a basis of allocation to product and to class of customer. If, on the other hand, the salesman must demonstrate or perform service work for one class of customer or of product, necessitating a longer call with one customer or one product than another, then the time spent on the call is significant and should be taken as the basis for cost allocation.

Let me say this in perhaps another way. In factory cost accounting either the direct labor dollar or the direct labor hours are used

quite generally as the basis for the application of factory overhead. In seeking a basis for applying direct and indirect selling expenses to product or customer, the call or the productive sales hour may serve as a basis for allocation in a similar way.

In order to determine the productive sales hours applicable to any customer class, it will be necessary to establish a system of salesmen's reports if such are not already available. Such a system should be designed to permit salesmen to report with a minimum amount of effort the productive time spent in the customer's interest. It has been found that this plan of reporting productive hours is very beneficial to sales management in more efficiently directing sales effort, as well as providing the basis for the distribution of selling expense.

Statistical records should be developed from such salesmen's reports, showing the total calls or productive hours for each product sales department and for each customer class as a basis for determining an average cost per call or productive hour for each product sales department and for each customer class. From these statistical records the cost of selling a particular customer or product may be determined whenever desirable. All strictly commission remuneration should be excluded from the cost of the call or from the productive hour cost as the commission cost of selling particular products or specific customers can be allocated specifically.

As in the factory, there are many indirect selling expenses and indirect sales departments which must be allocated or prorated to product or customer classes. Having developed the direct selling expense, we have a basis for distributing much of the overhead by methods similar to those used in factory costing. There may be some selling overhead expense that can be allocated directly to product or customer classes rather than as an over-lay on the direct expense. Wherever this is possible it should of course be done.

This may all sound very elementary to many of you, and I certainly hope it does because the point I am trying to make is that there is no mystery about distribution costing. The principles are those with which we are familiar, the units only with which we are dealing, are different.

*Bad Debt Expense*

There is one item of commercial expense which presents a somewhat different problem than most of the others and I just want to mention it briefly here. The allocation of bad debt expense to product or customer may mean an entirely different classification of customers from that usually made. I can see justification in this case for a classification based on credit ratings as this seems to be the only kind of classification which bears any relation to bad debt losses. It has also been brought to my attention that bad debts and cash discounts are related items, that you never have both applying to the same account. My reaction is that in allocating even to a specific customer he must be subject to the experience of the group within which he belongs and although he as an individual cannot both take a cash discount and create a bad debt, nevertheless experience has shown that his group does both and this group experience should apply. I recommend this to you as a line of thought which has been but little explored. I shall not take you any further in this direction.

*Conclusion*

There are other phases of the problem of control which are of importance, such as the preparation of reports, the use of the budget, the setting up of standards and the limiting of fixed overhead. These we must pass by for the time being. I do want to leave with you, however, this concept of a complete standard cost —one which does not stop at the factory door but which provides standards through the point of the final sale, both by product and by customer class, so that an answer is readily available to any questions of pricing or of sales policy.

If we are so provided, we can eliminate much of the worry as to whether our competitor is giving away his profit when he sells a jobber our $2.00 price article for $1.89, or when the Federal Trade Commission asks us how we happen to sell Jim Jones, a small retailer, at $2.50 and the same article to the XYZ chain for $2.05, we can answer readily and with assurance.

Perhaps I haven't told you a thing that is new, but if I have succeeded in putting the old stuff in a different package I am satisfied.

# FIXED AND VARIABLE ELEMENTS IN SELLING COSTS

**By Norman B. Clark, Head, Accounting Department, Woodbury College, Los Angeles, Calif.**

THE importance of distinguishing between the fixed and variable elements in selling costs hardly needs statement. There are many businesses where the selling and administrative costs are from one to five times the production costs. The dairy and liquor businesses are good illustrations. It would seem to be self-evident that, if possible, as detailed an analysis of these costs should be made as in the case of factory costs.

The following case will serve as an illustration: In a certain factory, distribution cost is almost 60 per cent of the total cost. Of the distribution cost, 22 per cent varies with the sales orders, and 29 per cent with the number of items ordered. This totals 51 per cent, and 51 per cent of 60 per cent is roughly 30 per cent of the total cost. If the company were able to induce its customers to combine orders into one-half as many orders, and to double the quantity of goods ordered at any one time, they could save half the cost of these services, or 15 per cent of the total cost of the sale.

In spite of the importance of this phase of accounting, I doubt if more than a small percentage of firms is doing much about it. Most accountants are inclined to look upon it as a subject for statistical analysis within the sales department. Possibly that is the right point of view, but even then it is certain that a much better job will be done if the accountants help to meet the statistical requirements of the sales department.

## *Points to be Considered*

I propose to discuss the subject of fixed and variable selling costs in the following way: First, I shall state what I conceive to be the objectives of such a program. Of what use is it? That question is frequently asked, and while I have said it would seem to be self-evident, apparently to many it is not. Next, I shall illustrate some of the difficulties which we shall have to solve. Then I shall try to draw some parallels and distinctions between production cost accounting and commercial expense cost account-

ing, which I hope will prove helpful in solving, or at least understanding, these difficulties. In addition, I shall review the ordinary methods of measuring these fixed and variable elements, and finally propose a method of handling them on the cost analyses.

*Fixed and Variable Costs in Pricing*

At the Atlantic City convention of the N. A. C. A. the theme was "Cost Accounting and Industrial Pricing." In price setting the question of fixed and variable costs becomes all-important. Every article has several prices, all justifiable under different conditions. Prices vary because of three factors: business conditions, production conditions, and what I might call distribution conditions. There is a minimum price below which no article should be sold, except under financial distress. This price should include the replacement value of the material used, the labor cost, the variable factory expense incurred and the variable commercial overhead incurred. This we might term the minimum depression price. Then there is what might be termed the normal, competitive price, which, in addition to all the foregoing, should include a fair share of the fixed factory and commercial expense, and a profit. Then there is what we might call an excess price which includes profits over and above normal profits, where monopolistic conditions obtain, or an extraordinary situation exists, or where during a boom a company attempts to build up reserves against depressions.

If the selling department is going to set prices intelligently, it would seem clear that it must be provided with figures which will tell it, first, just how far it can go in yielding to price pressure, and secondly, just what business policy is being expressed by such price concessions. It should make some reasonable attempt to take price setting out of the opportunistic class and put it on a scientific basis. I realize it is easier to advocate that than to do it, but nevertheless, it would seem to be part of intelligent leadership to attempt it.

*Fixed and Variable Costs in Distribution*

In the second place, there are factory conditions to be considered. You know the answers to that so I will go on to what I referred to as distribution conditions. Are you selling to wholesalers, jobbers, chain stores, voluntary chains, large retailers, small

retailers, consumers, mail order houses, manufacturers, or governmental units, and in this or that territory? What is fixed and variable will have importance in different degrees on the price policies used, and should constitute quite an item of defense against an attack under the Robinson-Patman Act. It would seem almost impossible to serve a great variety of customers in different territories with justice to all, without a clear measurement of the effects of fixed and variable selling costs on the problems in each instance. Of course many of the larger companies have their sales departments so departmentalized that many of these problems disappear.

Still another place where the distinction is serviceable, and in this case generally recognized and generally used, is in the preparation of budgets.

Finally, consider the ordinary objectives of any analysis of sales expense. Primarily, we analyze sales expense to learn the profitableness of territories, classes of customers, products and salesmen. Without making this distinction, the results lose a lot of their reliability and meaning. This is especially true when, following a common practice, fixed sales expenses are divided on the basis of the sales dollar. There are situations where that method is reasonable and serviceable, and in such businesses all of this discussion will have little meaning. But in a great many instances this condition does not exist.

I think these reasons I have given, price setting under changing economic and distribution conditions, budgetary considerations, and the customary analyses of sales costs, are sufficient to justify a far greater effort than is ordinarily made, especially by smaller business units, to find a satisfactory solution to this problem.

*Problems Arise Largely from Difficulty of Measurement*

Now to review some of the difficulties of the problem, which most of you understand only too well. As usual, there are two kinds of difficulties—difficulties of theory or principle, and difficulties of practice or measurement. In this particular case the difficulties of theory do not seem nearly as great as the difficulties of measurement. The cost of selling every article should include the variable cost attached to it plus a fair share of the fixed selling

cost under normal conditions. The rub comes in trying to measure these two factors.

As an illustration, let's look at the question of finding the cost of a salesman's call. He starts out on his itinerary, makes calls along the way, spends ten minutes on some and two hours on others, does a lot of business with some customers, none with others, but may be laying the groundwork for future business, takes a half day to go to a small town off the beaten path where he could not afford to go if he did not happen to be close by, and finally returns with a batch of orders which may be double or half what he got on the last trip, and they may be for quite different products or grades as well. How can you find regularity in all this irregularity? To what serviceable basis can all of this be reduced? And finally, how much of the cost of this shall we consider fixed and how much, if any, variable? Shall we reduce it all to a per call basis, dividing his total expenses by the number of calls made? If it happens that most of his customers were of the same type, that might be an adequate measure. But if he has several types of customers, with some of whom he spends long hours working out sales promotion plans, obviously the per call basis would be inadequate. Under such conditions a classification of customers with a division of the salesman's time between them would be necessary before a cost per call per type of customer could be obtained.

Or shall we make no attempt to find the cost per customer at all, but simply find the cost per $100 of sales? In doing that, which is a very common practice, it seems to me that there is a blind spot in the costs, because, to quote from Sinclair on budgets, "The ratio of selling costs may increase even though actual selling costs decrease, and there may be no real relationship between fluctuations in selling prices and fluctuations in selling costs." Or, to state it differently, you are running three variables together and losing sight of all, the first variable being the cost of the salesman's effort, the second, the effectiveness of the salesman's effort, and the third, the fluctuations in selling prices.

Then, how about this trip to an off-the-main-route customer? Shall a segregation of traveling expenses be made for that, or should it be averaged with the rest?

*Company Policies Often Determining*

If I seem to ask more questions than I answer it is because the answers are necessarily bound up with the policies of the business, and consequently there is no single answer. For instance, it may be the policy of the company to take business only when it can be shown that each unit of business sustains itself or it may go after a given volume, regardless of whether or not some units sustain themselves or not. Two entirely different answers may be given under these two sets of circumstances. In the first instance, we should want as close a division of costs as to territory, customer and product as is economically possible. In the second, an average cost will do. Of course, it sometimes seems as though some businesses have no price policies and for them there is no use trying to prescribe, other than to suggest that the loss on selling costs be written off to advertising.

In this connection may I digress to make a few comments about the relation between accounting principles and business policies? I have heard accountants, and especially cost accountants, criticized, because they do not have a dogmatic set of principles to govern each situation. They have been accused of selecting that method of accounting which best suits their purpose, with an implication that this was not quite scientific. Why shouldn't they? After all, cost accounting exists not only to record and control expenditures, but to express and guide the policies of the management, and I should say that cost accounting policies are inextricably bound up with business policies. There is no reason why one firm cannot, for instance, account for joint products in an entirely different way from another, and both still be right. And this observation applies also to the question under discussion, so there may be several answers to these questions—and all of them right. And beyond the broadest, most general underlying principle, which I have already stated, there can be few, if any, categorical statements.

*Factory and Commercial Costs Compared*

At this point let us turn to a comparison between factory costs and commercial costs. While they are alike in many respects, they have two very important differences. In a factory we are trying to make goods and we always make them; in the market we are

trying to make sales, but we don't always make them. In other words, in production costs we tie our costs to a definitely predictable result. If we take a properly trained man, put him to work on a certain machine for a certain length of time, give him certain materials, we can predict within a very small variation what the physical production will be, and our cost analysis problem becomes largely a question of accounting for the variations from definite standards of performance. In selling costs, as the situation is generally handled, it is quite different. When money has been spent for salesmen, with samples, advertising, etc. in proportions which should produce a certain quota of sales, there is no assurance that the sales will be forthcoming. We could, and some do, handle selling costs as we do production costs, that is, find what it costs per call, per order, per ton handled, per delivery, but these are not the end results. In most sales analyses, you will find the expenses expressed in unit costs per sales dollar, or per dollar of gross profit. That point of view completely shifts the basis and puts your selling costs on the least controllable basis, therefore introducing a large factor of unreliability.

*The Difficulty of Measuring Selling Costs*

The second respect in which selling costs differ most decidedly from manufacturing costs is in the difficulty of measurement. You can't use time-clocks, stop watches, scales and meters on most of your selling effort. Unless an organization is very large and has its sales department completely departmentalized, it is extremely difficult to find a thoroughly satisfactory basis for allocation of many selling expenses, and that is why reference is so frequently made to the sales dollar or the gross profit for a base.

But if there are differences, there are also many similarities. In process accounting we are generally trying to get the cost of a function reduced to a unit basis, and most selling cost analyses attempt to do exactly the same thing, and frequently in the same way.

*Functional Classification*

Let us turn to a consideration of the ordinary methods of handling selling costs and then relate our subject to them. But first,

let me observe that sometimes the analysis of selling costs becomes so complicated that it is not always feasible to introduce the analysis into the books, and it is preferable simply to let the accounting system be the basis for statistical analysis.

First of all, selling costs, under almost any treatment are subdivided into from two to ten functions. Seven common functions are: direct selling, advertising, transport, warehousing, credits and collections, financing expenses, and general or miscellaneous. To that might be added servicing costs, statistical costs, and sometimes, packing, although there seems to be some doubt regarding the latter. If you want to combine these into only two groups, they would be selling and distribution, that is, getting the order and filling the order. It is obvious that there are many fixed elements attached to each of these groups, and in some groups almost all of the elements are fixed or semi-variable. Warehousing is an example.

*Historical, Budgetary and Standard Cost Approach Compared*

After this common division, there are, as you all know, three common ways to handle selling costs—the historical method, the budgetary method and the standard cost method. If the historical method does not always seem to offer as much as the others, it is only because generally it does not attempt as much. Using the historical method, costs may be broken down not only into the functional groups, but into costs which vary with sundry physical measures, such as the territory, number of customers, number of orders, kind of product, size of order, number of items, etc., and unit costs obtained for all of these.

If these group totals are merely divided by the total units, on the one hand, or expressed as a percentage of sales, on the other, (two commonly used methods) the results are rather ambiguous. Changes in volume and price levels distort the figures. Let us refer to Exhibit I and consider Assumption A, a normal year. What constitutes a normal year for sales or sales expenses introduces problems all its own. Briefly, I should say that a normal year is one where, with the capital available, a volume of business at a

## EXHIBIT I

*Assumption A.* Normal or Basic Year

| | *Territory A* | % | *Territory B* | % | *Total* | % |
|---|---|---|---|---|---|---|
| SALES | $50,000 | | $50,000 | | $100,000 | |
| Selling Expenses: | | | | | | |
| Fixed | $ 5,000 | 10 | $ 5,000 | 10 | $10,000 | 10 |
| Semi-Fixed | 5,000 | 10 | 5,000 | 10 | 10,000 | 10 |
| Variable | 10,000 | 20 | 10,000 | 20 | 20,000 | 20 |
| | $20,000 | 40 | $20,000 | 40 | $40,000 | 40 |
| UNITS SOLD | 1,000 | | 1,000 | | 2,000 | |
| Unit Costs | | | | | | |
| Fixed | $ 5 | | $ 5 | | $ 5 | |
| Semi-Fixed | 5 | | 5 | | 5 | |
| Variable | 10 | | 10 | | 10 | |
| Total | $20 | | $20 | | $20 | |

*Assumption B.* 50% More Sales Effort
30% Gain in Territory A and Price Gain of $2,000
70% Gain in Territory B and Price Loss of $2,000

| | | | | | | |
|---|---|---|---|---|---|---|
| SALES | $67,000 | | $83,000 | | $150,000 | |
| Selling Expenses: | | | | | | |
| Fixed | $ 4,467 | 6.7 | $ 5,533 | 6.7 | $10,000 | 6.7 |
| Semi-Fixed | 5,360 | 80. | 6,640 | 8.0 | 12,000 | 8.0 |
| Variable | 15,000 | 22.4 | 15,000 | 18.1 | 30,000 | 20.0 |
| | $24,827 | 37.1 | $27,173 | 32.8 | $52,000 | 34.7 |
| UNITS SOLD | 1,300 | | 1,700 | | 3,000 | |
| Unit Costs | | | | | | |
| Fixed | $ 3.44 | | $ 3.25 | | $ 3.33 | |
| Semi-Fixed | 4.12 | | 3.90 | | 4.00 | |
| Variable | 11.54 | | 8.82 | | 10.00 | |
| Total | $19.10 | | $15.97 | | $17.33 | |

*Assumption C.* Same Figures as B, but distribution of expenses adapted to a Flexible Budget method.

| | | | | | | |
|---|---|---|---|---|---|---|
| SALES | | | | | | |
| Budgeted | $65,000 | | $85,000 | | $150,000 | |
| Actual | 67,000 | | 83,000 | | 150,000 | |
| Selling Expenses: | | | | | | |
| Fixed | $ 5,000 | 7.5 | $ 5,000 | 6.0 | $10,000 | 6.7 |
| Semi-Fixed | 6,000 | 8.9 | 6,000 | 7.2 | 12,000 | 8.0 |
| Variable | 15,000 | 22.4 | 15,000 | 18.0 | 30,000 | 20.0 |
| | $26,000 | 38.8 | $26,000 | 31.2 | $52,000 | 34.7 |
| UNITS SOLD | 1,300 | | 1,700 | | | |
| Unit Costs | | | | | | |
| Fixed | $ 3.85 | | $ 2.94 | | $ 3.33 | |
| Semi-Fxed | 4.61 | | 3.52 | | 4.00 | |
| Variable | 11.54 | | 8.82 | | 10.00 | |
| Total | $20.00 | | $15.28 | | $17.33 | |

*Assumption D*

| | | | % | *Unabsorbed* |
|---|---|---|---|---|
| SALES: | $67,000 | | | |
| Price Gain | 2,000 | | | |
| | | $65,000 | | |
| Selling Cost Absorbed | | | | |
| Fixed Costs (5/75 of 65,000) | | 4,333 | 6.5 | $ 667 |
| Semi-Fixed (6/75 of 65,000) | | 5,200 | 8.0 | 800 |
| Variable (15/75 of 65,000) | | 13,000 | 20.0 | 2,000 |
| Cost of Ineffective Selling Effort. | | | | $3,467 |
| UNIT COSTS: | | | | |
| Fixed | $ 3.33 | | | |
| Semi-Fixed | 4.00 | | | |
| Variable | 10.00 | | | |
| | $17.33 | | | |

rate of profit sufficient to net a reasonable return on the capital is obtainable. That, of course, is an over-simplification of the problem, and the definition has a few variables within it.

Now let us assume that 50 per cent more sales effort was put forth in both Territories A and B, but that in Territory A the increase in sales units was only 30 per cent with a price gain of $2,000, whereas in Territory B the gain was 70 per cent with a price loss of $2,000. Under Assumption B, the ordinary method of distribution selling expenses is shown, that is, the fixed and semi-fixed have been distributed as percentage of sales, and the variable has been charged directly to territories, although even the variable expenses are sometimes put on a percentage basis. The results are entirely misleading. In Assumption C, where the fixed and semi-fixed expenses have been distributed according to the budgetary estimates of the sales effort, we come much closer to the actual situation.

It is assumed that there is a way of distributing the variable expenses on the basis of sales effort made. But even this method does not tell us what the selling cost ought to be, and consequently, we make the further analysis shown in Assumption D. The price gain is shown, together with the correct percentage of selling cost on the basis of results and the loss from ineffective selling effort (which in the factory would be called unabsorbed burden). A unit cost of selling, which is substantially less than in the other two methods, appears.

*Use of Flexible Budget and Standard Costs*

A flexible budget, as ordinarily used, sets the expenses by different levels of sales, then selects the particular budget to be used by reference to the sales level obtained. Here again it would seem that this is the wrong basis, for it presupposes that sales results in any territory or product are proportionate to sales effort, which is known to be wrong. If the flexible budget chosen depended on sales effort made (as measured by direct selling costs, or sales calls, or salesman's days in a territory), the results would be more useful. The budget in that case would appear as the actual figures in Assumption C and a comparison between this budget and what-

ever figures happened to occur, would give the over and under amounts for the budget report.

In the case of standard costs, which seem even more desirable for measuring selling effort than manufacturing effort, the variable elements would be reduced to a standard unit basis, multiplied by the units used, and compared with the costs. So far as the fixed and semi-fixed expenses are concerned, the standard figure being set much as the budgetary figure in Assumption C was set, the comparison will be first as to the size of the expenditure and then as to the amount of absorption.

In the last analysis, therefore, our problem resolves itself into a decision of how the fixed charges are going to be allocated to this or that territory, product, etc. The general practice is on the basis of the sales dollar, actual or budgeted. If the budgeted basis represents a fair expectancy of the sales effort put forth, as it normally would, that basis will result in a logical distribution. If sales efforts and results usually run in proportion for various departments or territories, that basis indirectly leads to a distribution which may be accurate enough for practical purposes. But should it happen that sales effort and sales results vary widely, as in many businesses, the sales effort as measured by actual figures, or as budgeted, would seem to be the logical basis.

I have spoken largely in terms of totals and groups for the sake of brevity. Suppose you were called on to justify a reduction of price to a large buying syndicate. How would you do it? First you would show any manufacturing economies resulting, especially from the reduction in the fixed charges per unit. Then you would show any reduction in the variable selling and distribution costs. Finally, you would come to the question of the fixed selling and distribution costs, where substantial savings are available. How would you measure them? If this fixed expense were added on the basis of the sales value, a large part of the logical deduction is lost. If this expense is based on a ratio to the direct selling expense or selling effort, a substantial saving would probably show up.

*Summary*

To summarize, after our selling expenses have been broken down into functional costs, they must be divided into variable and

fixed elements. The variable elements must be allocated to territories or products on a unit basis, and the fixed costs must be prorated on an arbitrary basis. The usual basis is the sales dollar or the sales budget, but it is the contention of the author that it should be applied on the basis of direct selling costs. With such a procedure, it is possible to show the cost of ineffective selling effort, what it ought to cost to sell goods by territories or product groups or classes of customers under varying conditions.

One final warning. To attempt to refine the costs beyond the general, yet very useful points indicated above, such as finding the cost of selling products by types of customers within territorial divisions, probably introduces a degree of fictitious accuracy into the figures, but even that may serve a useful purpose.

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